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No. 93

In the Supreme Court of the United States

OCTOBER TERM, 1945

HERCULES GASOLINE COMPANY, INC., PETITIONER

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH
CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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v.

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OPINIONS BELOW

The memorandum opinion of the Tax Court of the United States (R. 98-102) is unreported; the opinion of the Circuit Court of Appeals (R. 114-117) is reported at 147 F. 2d 972.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 1, 1945 (R. 119). The petition for rehearing was denied on April 19, 1945 (R. 123). The petition for a writ of certiorari was filed on May 28, 1945. The jurisdic-

tion of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether petitioner's transferor corporation was entitled, under Section 26 (e) (1) of the Revenue Act of 1936, to a credit against undistributed profits tax for 1937, where the claim for credit rested upon a provision of the transferor's stock certificates.

STATUTES INVOLVED.

Revenue Act of 1936, c. 690, 49 Stat. 1648, 1664:

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. * * *

* * * * *

STATEMENT

The pertinent facts, taken from the findings of the Tax Court (R. 92-98), are as follows:

The petitioner is a Delaware corporation organized in 1939 and domiciled in Wilmington. It admits liability as transferee of the assets of Hercules Gasoline Company, Inc. (hereinafter called the transferor), a Louisiana corporation, which was dissolved in 1939. (R. 92-93.)

The original charter of the transferor duly filed and recorded in the state of its domicile in 1933 contained the following (R. 93-94):

ARTICLE V

The capital stock of this corporation is hereby fixed at 3,000 shares of no par value common stock and 400 shares of \$50.00 par value of preferred stock, which said stock shall be paid for in cash at the time of issuance or for service rendered or property actually received and shall be full-paid and nonassessable.

The following rights, privileges and conditions shall attach to the shares aforesaid, viz:

(a) The preferred stock shall be entitled, out of any and all surplus net profits whenever declared by the Board of Directors, to cumulative dividends at the rate of 8% per annum for each and every year from the issuance of such stock, payable semi-annually, in preference and priority to any

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payment of any dividend on the common stock for such year.

* * * * *

(c) The common stock shall be subject to the prior rights of the holders of the preferred stock as above declared and there shall be no dividend on the common stock until all of the preferred stock has been retired, redeemed and discharged.

* * * * *

At a meeting of the stockholders of the transferor held in 1935, a resolution was adopted to amend the charter in order to increase the authorized number of shares of preferred stock from 400 to 1,400, which amendment was duly filed and recorded. The amendment as contained in the resolution and as made to the charter was in the same language as that contained in Article V of the original charter except that the number of shares of preferred stock was shown as 1,400 instead of 400. (R. 94-95.)

All certificates of preferred stock, whether issued before or after the amendment to the charter, contained the following provision (R..95):

For Rights and Voting Powers of Preferred Stock See Article V of Charter.

During 1937 and 1938 the transferor had outstanding 1,294 shares of preferred stock of a total par value of \$64,700, all of which had been issued prior to May 1, 1936, and all of which were retired in 1939 (R. 95).

In assessing the deficiency for 1937, the Commissioner determined that the provision in the transferor's charter which prohibited the payment of dividends on common stock so long as any of the preferred stock was outstanding, did not constitute a contract prohibiting the payment of dividends within the meaning of Section 26 (c) (1) of the Revenue Act of 1936 (R. 96-97). The Commissioner was sustained in the Tax Court, and the Circuit Court of Appeals, with one judge dissenting (R. 117-119), affirmed (R. 114-117).

ARGUMENT

This case does not warrant further review because it was correctly decided in accordance with principles enunciated by this Court in *Helvering v. Northwest Steel Mills*, 311 U. S. 46, and the statutory provision involved has been superseded. While we concede that the Court of Claims¹ and the Circuit Court of Appeals for the Third Circuit² do not share the view of the majority below and of the other Circuit Courts of Appeals³ that

¹ *Ree-Hanover Mills Co. v. United States*, 53 F. Supp. 235.

² *Lehigh Structural S. Co. v. Commissioner*, 127 F. 2d 67; cf. *Monarch Theatres v. Helvering*, 137 F. 2d 588 (C. C. A. 2d).

³ *Warren Tel. Co. v. Commissioner*, 128 F. 2d 503 (C. C. A. 6th), certiorari denied, 317 U. S. 697; *Elliott Addressing Machine Co. v. Commissioner*, 131 F. 2d 700 (C. C. A. 1st). See also *Commissioner v. F. G. Atkins & Co.*, 127 F. 2d 783 (C. C. A. 7th); *Atlas Supply Co. v. Commissioner*, 123 F. 2d 356 (C. C. A. 10th); *Martin Realty & Min. Co. v. Commissioner*, 130 F. 2d 1003 (C. C. A. 8th).

the *Northwest Steel* decision requires the denial of credit where, as here, the dividend restriction relied on is embodied in a contract within the corporate framework rather than outside it, we believe that at this date there is small reason for this Court to resolve the divergency of opinion. Later revenue laws contain no provision corresponding to Section 26 (c) (1) of the 1936 Act, *supra*, p. 2, and the number of cases still concerned with that Section is consequently unappreciable. Furthermore, before questioning the applicability of the *Northwest Steel* decision, the petitioner must hurdle the fact that the provision relied upon does not actually prohibit the payment of dividends but is merely an intracorporate agreement as to priorities in their payment. See the opinion on rehearing in *Budd International Corp. v. Commissioner*, 143 F. 2d 784, 793 (C. C. A. 3d), certiorari denied, 323 U. S. 802.

The courts which hold that under the *Northwest Steel* decision credit is not allowable where corporate charter or stock certificates contain the critical provision^{*} ground their opinion principally on this Court's statement in that case that the kinds of agreement which Congress had in mind in Section 26 (c) (1) were "routine contracts dealing with ordinary debts" (311 U. S. at p. 50). Manifestly, a promise by a corporation to some of its shareholders that it

^{*} See fn. 3, *supra*, p. 5.

will not pay dividends to other shareholders except under specified conditions is not a routine contract dealing with ordinary debts. As the majority opinion below states (R. 117)—

The shareholders of a corporation are not its creditors; they are its owners.

It was to corporations which were contractually obligated to set aside earnings for the protection of creditors that Congress intended to afford the grace of Section 26 (c) (1).^{*}

It is true that the precise question in the *North-west Steel* case was whether a state statute prohibiting dividend payments under certain conditions was a "contract" provision within the meaning of Section 26 (c) (1). But the argument there ran in part that the state statute was an implied-in-law term of the corporation's charter, and therefore the taxpayer necessarily was urging

^{*} See the following remarks of Representative Samuel B. Hill, Chairman of the Subcommittee on Taxation of the Committee on Ways and Means (80 Cong. Record 6004):

* * * I am now going to call attention to section 15, which deals with contracts not to pay dividends. If a corporation as of March 3, 1936, finds itself in a position, *by reason of a contract entered into with its creditors*, not to pay dividends until it has paid its creditor his debt or has established a sinking fund, or otherwise provided means of paying the obligation, if it is under that handicap by reason of a written contract, then we allow the corporation a 22½-per-cent flat rate on that portion of the net income which it is unable to pay out, by reason of this contract, in dividends. [Italics supplied.]

that the charter itself was a "contract" within the intendment of the federal statute. Hence we think that this Court's statement that the kind of agreement to which Congress had reference was a routine contract dealing with ordinary debts was more than mere dictum (cf. Pet. 11). Moreover, this Court further stated in the *Northwest Steel* case that, conceding a corporate charter to be a "contract" for some purposes—

it does not follow that Congress intended to include corporate charters and related state laws in the cautiously limited area permissible for tax credits and deductions under this section (311 U. S. at p. 51).

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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